

Governmental Accounting Standards Board (GASB 31)

By Paul Duren and Steven Alexander

“Overall, the introduction and the implementation of GASB Statement 31 has not been the financial nightmare that many had once predicted.”

U Auditing Update presented by Dr. Freeman was the application of Statement 31 of the Governmental Accounting Standards Board (GASB). Over the past two years, several finance officers have contacted me to ask questions about Statement 31. Therefore, I have asked Steven Alexander, Investment Managing Consultant, at Public Financial Management, Inc. to provide information regarding Statement 31.

Approximately one year ago, the Government Accounting Standards Board known as GASB introduced Statement 31 (Statement), which became a reality for most public entities. Did it achieve the effect that the GASB sought? The Statement addresses the methods used to report investments in the financial statements of all public entities.

Historically, public entities accounted for investments at cost or some method of amortized cost. For decades, these methods were acceptable accounting practices, while the private sector had migrated to the lower of cost or market accounting method years ago. As interest rates fell in the early 1990s, public entities began investing in a wide array of risky and unsuitable investment vehicles in order to capture higher yields. Unfortunately, this yield chasing by local governments entices a number of security brokers and dealers to push and market investment products that promised to produce higher returns with no mention by the broker of the extreme market risk associated with derivatives. Not until the later part of 1994 and early 1995 were governments forced to announce the significant market losses on their investment portfolios, most notably Orange County, California.

The lack of understanding of current accounting policies may have been a contributing factor to the partial liquidation of the TexPool Fund. The TexPool, Texas' version of the Florida State Board of Administration (SBA), crisis demonstrated that pools needed to change their

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current financial reporting practices.

Concerned parties, including pool participants, rating agencies and auditors began questioning the practices that permitted market value losses to be unrecognized, thus overstating the balance sheet and fund balances. GASB's answer to these concerns was Statement 31, which became effective for fiscal years beginning after June 15, 1997. The two most significant changes imposed by this Statement on financial reports are summarized as follows:

In fiscal years beginning after June 15, 1997, public entities are required to report investments at fair value, rather than cost or amortized cost on the balance sheet or other statements of financial position (not just as a footnote to the financial statements). Fair value is defined as the value that can be agreed upon between parties in other than a forced liquidation, in other words under normal business conditions.

Public entities are required to recognize the unrealized gains and losses in their financial statement as they occur. It is GASB's understanding that if public entities had recorded their investments at fair market on the balance sheet, the significant market losses of 1994 and 1995 may have been avoided. There are two important notable exceptions to the Statement's requirements: securities that at the time of purchase have one year or less until maturity and nonparticipating investment contracts can both be recorded at cost or amortized cost.

In the dynamic arena of investments, currently it is hard to ascertain the direct financial impact that the Statement has

eral shortened in duration because of falling rates or have they shortened in duration because of the exception from fair value accounting requirements of Statement 31? According to Randal Finden, the GASB project manager for Statement 31, "We have been blessed with a benign investment environment, making it hard to assess the impact of this Statement on portfolios." GASB has begun a study to analyze the disclosures made in this the first full year of implementation, to determine what effect, if any, Statement 31 has had on influencing investment policies and procedures. Only those public entities that have specific assets that are being held to match identified long-term liabilities, for example, Housing Authorities or Lottery Agencies, have expressed an ongoing opposition to the Statement.

The Statement also addressed the accounting for external investment pools. If a public entity deposits funds into an investment pool, whether or not sponsored by a governmental entity, the funds are required to be recorded at fair value on the public entity's financial statements. The burden has been placed on the pool's participants to obtain the fair value of the pool's underlying portfolio. Again, there is an exception: if the pool is operated in manner consistent with rule 2a-7 of the Investment Company Act of 1940, the funds can be recorded at amortized cost. This is the first time that the GASB has used a legal standard to determine accounting guidelines. This exception has forced sponsors of local government investment pools to determine if they want to operate as a 2a-7 like and maintain a constant asset value. According to Standard & Poor's: 18 state-operated pools have converted to 2a-7 like standards (including the SBA Local Governmental Investment Pool), 12 states have decided not to convert to 2a-7 standards and 20 states do not have investment pools.

The conversion to 2a-7 like standards brings with it a variety of issues.

Stringent investment guidelines that include a weighted average portfolio duration of not more than 90 days and diversification is provided by limiting investments to 5 percent in one issuer unless the securities are of the United States government. Additionally, pools cannot invest in securities with maturities over 397 days, and the individual security credit ratings must be in the top tier grade level. The decision not to convert to a 2a-7 like pool brings with it the burden of educating the pool participants on the impact of a fluctuating share price value (Net Asset Value), as well as the potential for a rush to redeem shares if the participants become anxious during a rising interest rate environment.

Overall, the introduction and the implementation of GASB Statement 31 has not been the financial nightmare that many had once predicted. Most state and local governments had followed conservative investment practices, and prior to the issuance of this Statement, over 50 percent of public entities were "marking to market" their investment holdings on some periodic

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basis. However, the Statement did increase the reporting requirements, and most importantly, raised the communication between finance officers and governing boards. The Statement also caused sponsors of external pools to re-examine their investment objectives and increase reporting to pool participants. This I believe is exactly what GASB intended to give readers of financial reports – an accurate description of the investment portfolio known as fair value. ■

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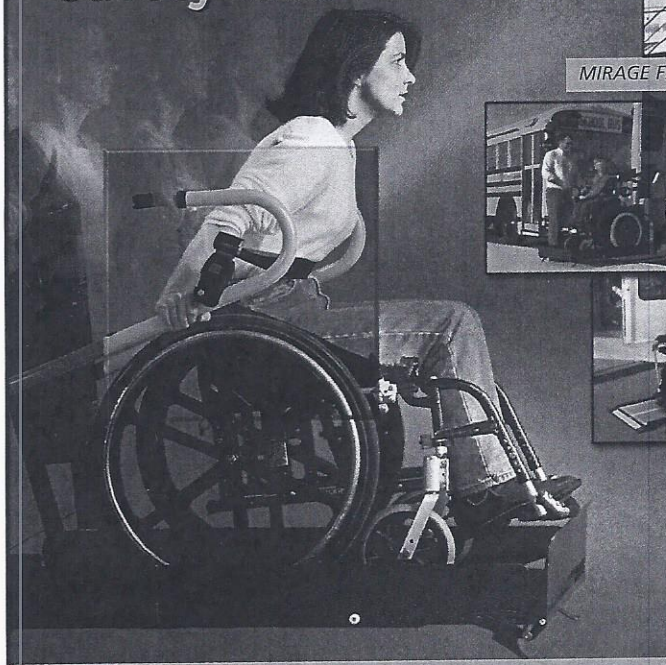
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